Q1 2021 | Putnam Floating Rate Income Fund Q&A

Loans outperform amid rising rates, demand for yield

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Bank loans gained about 2% in the first quarter, aided by rising longer-term interest rates and demand for higher-yielding securities.

Security selection and underweight allocations in the outperforming technology and services sectors detracted from relative performance this quarter.

We have a generally positive intermediate-term view on the market's fundamental environment and supply-and-demand backdrop.

How did the fund perform for the three months ended March 31, 2021?

The fund's class Y shares rose 0.81%, trailing the 1.78% return of the benchmark S&P/LSTA Leveraged Loan Index.

What was the fund's investment environment like during the first quarter of 2021?

High-yield bank loans posted a solid gain in the January–February period, aided by better-than-expected corporate earnings, before pulling back somewhat in March. Encouraging vaccine news bolstered investor optimism about the strength of the economic recovery in 2021. A $1.9 trillion Covid-19 aid package signed into law by President Biden in early March provided a further boost to market sentiment. Concerns about the potential inflationary impact of additional stimulus on top of an already-recovering economy led to an exodus from government bonds, which drove longer-term interest rates higher.

Rising interest rates provided a favorable backdrop for loans during the quarter, given their floating-rate feature. After beginning 2021 at 0.93%, the yield on the benchmark 10-year U.S. Treasury note reached 1.74% by March 31. Historically, investors have used loans as a tactical hedge against rising interest rates.

New issuance of loans reached the second-highest quarterly total on record during the period, as issuers sought to capitalize on historically low yields. Loan funds, meanwhile, reported consistently strong inflows throughout the quarter.

Within this environment, loans outpaced both high-yield bonds and the broad investment-grade fixed-income market for the quarter.

In the fund's benchmark, every cohort but one posted a gain, led by energy and gaming, lodging & leisure, each of which advanced about 4%. Additional outperformers included metals & mining, consumer products, transportation, and services, with each rising about 3%. Conversely, broadcasting [-1%], cable & satellite [+1%], and utilities [+1%] underperformed the index. From a credit-rating perspective, lower-quality loans generated the highest gains, signaling a comfort level with risk as investors sought higher yields.

What factors had the biggest influence on the fund's relative performance?

Versus the benchmark, security selection and underweight allocations in the outperforming technology and services sectors were the biggest negatives. Adverse overall positioning in health care and picks in gaming, lodging & leisure also hampered relative results.

What is your outlook for the bank loan market over the coming months?

We have a generally positive outlook overall. Although we expect the ongoing global health crisis to affect the high-yield loan market, we have a constructive intermediate-term view of corporate fundamentals and the market's supply-and-demand backdrop. Also, even though loan spreads retightened following their sizable widening in March, and compressed further on favorable vaccine news, we think valuations remain relatively attractive. [Spreads are the yield advantage loans offer over comparable-maturity U.S. Treasurys.]

From a fundamental perspective, we continue to closely monitor sectors that were heavily affected by the pandemic, such as energy; gaming, lodging & leisure; and retail. Within these groups, we are focusing on the health of issuers' balance sheets and liquidity metrics as well as the risk of defaults or credit-rating downgrades.

Due to the Covid-19 pandemic, loan defaults in 2020 exceeded our expectations. In 2021, however, we believe broad vaccine distribution and fewer defaults in the energy sector should lead to a reduced level of overall defaults.

As for supply/demand dynamics, loan new issuance surged in February to the fourth-highest monthly total on record and reached $301.4 billion for the quarter, a 52% increase over the same period in 2020. On the demand side, after registering outflows for most of 2020, loan funds [mutual funds and exchange-traded funds] posted inflows of $11.1 billion for the first quarter. Since rising rates have historically led to greater demand for loans, if interest rates continue to move higher, we believe investor capital will continue to flow into the asset class.

Collateralized loan obligations [CLOs] continued to be a substantial source of loan demand this period. [CLOs bundle corporate loans and sell slices of the debt to institutional investors.] In February, gross CLO volume reached the highest monthly total ever recorded. For the quarter as a whole, CLO volume equaled $106.4 billion, compared with $41.8 billion in the first quarter of 2020.

CLOs now account for roughly two thirds of the total assets in the loan market, while retail funds represent only about 10%. As a result, despite a substantial increase in loan supply, we think the market's technical environment is favorable. Stronger demand from both retail investors and CLOs is meeting higher-net new loan issuance.

From a valuation standpoint, the average yield spread of the fund's benchmark tightened to 4.4 percentage points over U.S. Treasurys as of period-end, below the long-term average of six percentage points. The benchmark's yield was 4.89% as of March 31, significantly below its 11-year average of 7.33%. Optimism over continued government stimulus and vaccine distribution drove loan prices higher and yields lower during the period. Despite tighter spreads and lower yields, we think the market's income potential remains attractive in the face of much lower global yields.

Putnam Floating Rate Income Fund (PFRYX)

Annualized total return performance as of 3/31/21

Class Y shares Inception 10/4/05	**Net asset value**	**S&P/LSTA Leveraged Loan Index (LLI)**
Last quarter	0.81%	1.78%
1 year	15.11	20.71
3 years	2.68	4.14
5 years	3.94	5.28
10 years	3.65	4.25
Life of fund	3.65	4.70

Total expense ratio: 0.78%

Returns for periods of less than one year are not annualized.

Current performance may be lower or higher than the quoted past performance, which cannot guarantee future results. Share price, principal value, and return will vary, and you may have a gain or a loss when you sell your shares. Performance assumes reinvestment of distributions and does not account for taxes. For the most recent month-end performance, please visit putnam.com. Class Y shares before their inception are derived from the historical performance of class A shares (inception 8/4/04), which have not been adjusted for the lower expenses; had they, returns would have been higher. For a portion of the periods, this fund may have had expense limitations, without which returns would have been lower. Class Y shares are generally only available for corporate and institutional clients and have no initial sales charge.

The S&P/LSTA Leveraged Loan Index (LLI) is an unmanaged index of U.S. leveraged loans. You cannot invest directly in an index.

The views and opinions expressed are those of the portfolio managers as of March 31, 2021, are subject to change with market conditions, and are not meant as investment advice.

Consider these risks before investing: The value of investments in the fund's portfolio may fall or fail to rise over extended periods of time for a variety of reasons, including general economic, political, or financial market conditions; investor sentiment and market perceptions; government actions, geopolitical events, or changes, and factors related to a specific issuer, geography, industry, or sector. These and other factors may lead to increased volatility and reduced liquidity in the fund's portfolio holdings. Lower-rated bonds may offer higher yields in return for more risk. Bond investments are subject to interest-rate risk (the risk of bond prices falling if interest rates rise) and credit risk (the risk of an issuer defaulting on interest or principal payments). Interest-rate risk is generally greater for longer-term bonds, and credit risk is generally greater for below-investment-grade bonds. Unlike bonds, funds that invest in bonds have fees and expenses. Risks associated with derivatives include increased investment exposure (which may be considered leverage) and, in the case of over-the-counter instruments, the potential inability to terminate or sell derivatives positions and the potential failure of the other party to the instrument to meet its obligations. Floating-rate loans may reduce, but not eliminate, interest-rate risk. These loans are typically secured by specific collateral or assets of the issuer (so that holders of the loan, such as the fund, have a priority claim on those assets in the event of the issuer's default or bankruptcy). The value of collateral may be insufficient to meet the issuer's obligations, and the fund's access to collateral may be limited by bankruptcy or other insolvency laws. Our investment techniques, analyses, and judgments may not produce the outcome we intend. The investments we select for the fund may not perform as well as other securities that we do not select for the fund. We, or the fund's other service providers, may experience disruptions or operating errors that could have a negative effect on the fund. You can lose money by investing in the fund.

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